Summary
- There are similar residual risks for different endgame solutions, with bulk annuities and a consolidator endgame more likely to present issues than self-sufficiency.
- The administrative work required to avoid residual problems is significant.
- Insurance cover can be obtained against residual risks.

Not quite the end…

Alex Janiaud considers how DB schemes can best manage residual risks after an endgame solution

Surging pension scheme funding levels have encouraged trustees to bring forward plans for endgame solutions. But an endgame – be it a buy-in or buyout, consolidation or self-sufficiency – carries residual risks that merit trustees' careful attention.

A September 2023 survey of 84 schemes by consultancy WTW revealed that, over the course of the year, improved funding levels had enabled 54 per cent of schemes to advance their endgames. Forty-one per cent of schemes had not changed their timelines for endgame, while 5 per cent had delayed their plans.

The residual risks faced by trustees after an endgame solution depend on the type of endgame, says law firm Linklaters partner, Philip Goss. "There are similarities at their core," he continues, including incorrect scheme data, missing beneficiaries and even the risk that the law is changed in a way that boosts the scheme's liabilities.

"We have seen 'residual risk' issues arise after endgame solutions have been achieved," Goss says, who adds that these have tended to affect only individuals or small groups of members, and have not required material benefit changes for large numbers of members.

"Residual risks can often be seen as 'low likelihood but high potential impact'," he continues. "They are not likely to arise, but if they do, the potential materiality could be very significant – there is typically no upper limit on how large the additional liability could be."

With the arrival of consolidator vehicles, the endgame options available to trustees are growing. Research from scheme services provider Brightwell indicates a degree of uncertainty surrounding endgames among larger schemes.

Published in March, Brightwell's January survey of 27 defined benefit schemes larger than £1 billion found that 41 per cent of those surveyed are undecided about their endgame, while 33 per cent are targeting buyout and 26 per cent are aspiring for run off.

Risk transfers can cause more problems

Consultancy Broadstone head of trustee

services, Chris Rice, believes that some endgame solutions can present more residual risks than others.

"A risk transfer (insurance or consolidation) approach throws up more challenges as it is necessary to complete due diligence to ensure any problems have been uncovered while the scheme is ongoing," he says.

"Much of this due diligence needs to be shared with indemnity insurers," he continues, "to allow cover to be provided and at a reasonable price."

"Run-on allows the scheme to address any data or benefit issues more slowly than a risk transfer as there is time. With a buyout time is often of the essence to ensure that the buyout price that has been secured can be transacted."

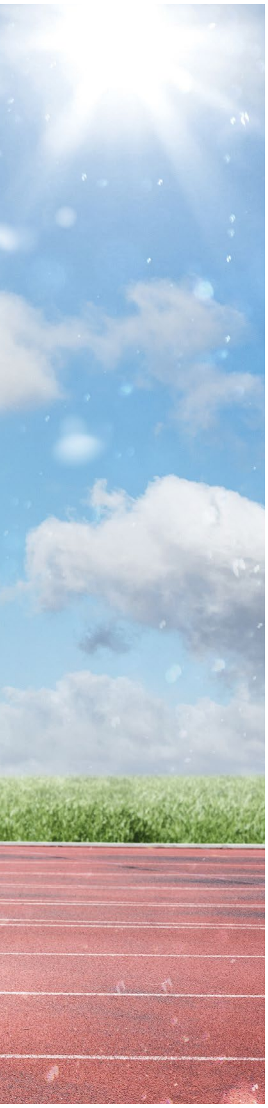
Consultancy Muse Advisory chief executive officer, Ian McQuade, says that while the preparation for a risk transfer is onerous, there are many overlooked activities that need to be handled after a buy-in.

"From an administration point of view, the work to prepare for buyout is significant," he says.

"In many cases, the effort in getting contractual and investment matters sorted will have been the priority up to the point of signing the buy-in," McQuade continues.

"Unless the scheme is in the fortunate position of having dealt with all the administration matters ahead of the buy-in (and few are), the hard work on administration really kicks off after signing. There is likely to be data cleanse work required, and potentially benefit rectification matters that have been identified through the process to be resolved."

Most trustees will check member records and ensure the information they



hold is correct before they approach the market for a bulk annuity, says law firm Squire Patton Boggs partner, Kirsty McLean. They will also have to prepare a benefits specification, which translates the rules and the benefits of the scheme into a schedule, setting out how individual benefits are calculated, to inform how an insurance policy pays out.

A data cleanse period takes place for two years after a bulk annuity policy is signed, in which the insurer will check every member's benefits line by line, McLean continues.

"By the time you get to final buyout and wind-up, you have crawled over everything you possibly could," she says.

"At that point, trustees should have a really high degree of confidence that they are providing the right benefits."

Consolidators offer less protection

There are nuances between the management of residual risks between risk transfers and consolidation endgame solutions.

"One key distinction between buy-in/out and consolidation endgames here is that the insurance provider may be offering 'residual risks cover', which is insurance against residual risks arising after the policy incepts," Goss says. This would be in addition to the core insurance, in respect of the known benefit liabilities of the scheme, and for which the insurer would charge an additional premium, he adds.

"My understanding is that, at least at present, consolidator vehicles do not offer this type of protection – they will typically only take on responsibility for the known and identified benefits at the point of transfer, and will exclude any residual risks," Goss continues. "As such, a consolidator endgame may offer less protection against residual risks."

Trustees considering self-sufficiency, on the other hand, are spared the lengthy data cleansing obligations that are imposed upon those considering buy-ins, buyouts or consolidators.

"Whilst many trustees think that once the buy-in is complete, the governance should get easier, the reality is the opposite"

"A self-sufficiency endgame is fundamentally different to buy-in/out and consolidator endgames in this regard, because there is no obligation to undertake any of these diligence and scheme cleanse processes," Goss says.

"As the scheme is effectively just running on (on a well-funded basis), the trustees do not need to go through any specific process to review historic and current practices and benefits and there will not be a third party carrying out any due diligence on the scheme," he continues.

"As such, it is much less likely that issues will be identified as part of achieving a self-sufficiency endgame than a buy-in/out or consolidator endgame."

Goss is seeing more schemes going through cleanse processes as a matter of good governance irrespective of their chosen endgame, "in some cases ahead of any decision being made on what their endgame solution will be".

"While trustees are not obliged to carry out such a process, it does seem a sensible approach to take, and we would support it for schemes targeting self-sufficiency as their endgame," he adds.

Governance can get harder once buy-in is complete

Law firm Eversheds Sutherland legal director, James Ellis, lists a number of measures that trustees can take to mitigate against residual risks.

He advises "detailed preparation, including consideration of the scheme's history and validity of benefit changes", while trustees can also secure "ongoing indemnification from the employer".

Residual risk insurance is also an option, "although consideration will need to be given to any exclusions in cover and whether the scheme is of sufficient size for such cover to be offered", he says. Separate run-off insurance exists with the same caveats.

McQuade notes that "whilst many trustees think that once the buy-in is complete, the governance should get easier, the reality is the opposite".

While the scheme's investment matters should have been simplified once the process is complete, in many cases some illiquid assets will need to be managed, McQuade observes. "There are so many moving parts that having strong and independent programme management is critical," he says.

"This role is akin to the conductor of an orchestra," he continues. "The orchestra maybe able to operate without a conductor, but it will be a far better experience for everyone concerned when one is in place, as everyone knows exactly what to do and when.

"Crucially everyone will know and be assured as to when they have reached the end of their journey. That will be the time to celebrate."

Written by Alex Janiaud, a freelance journalist